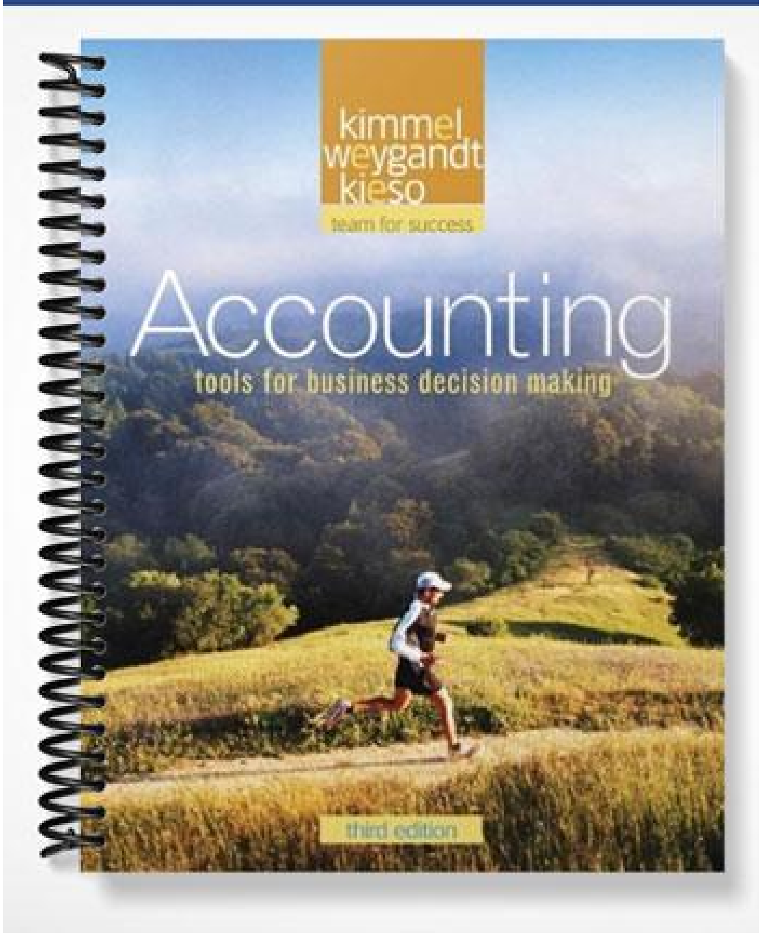
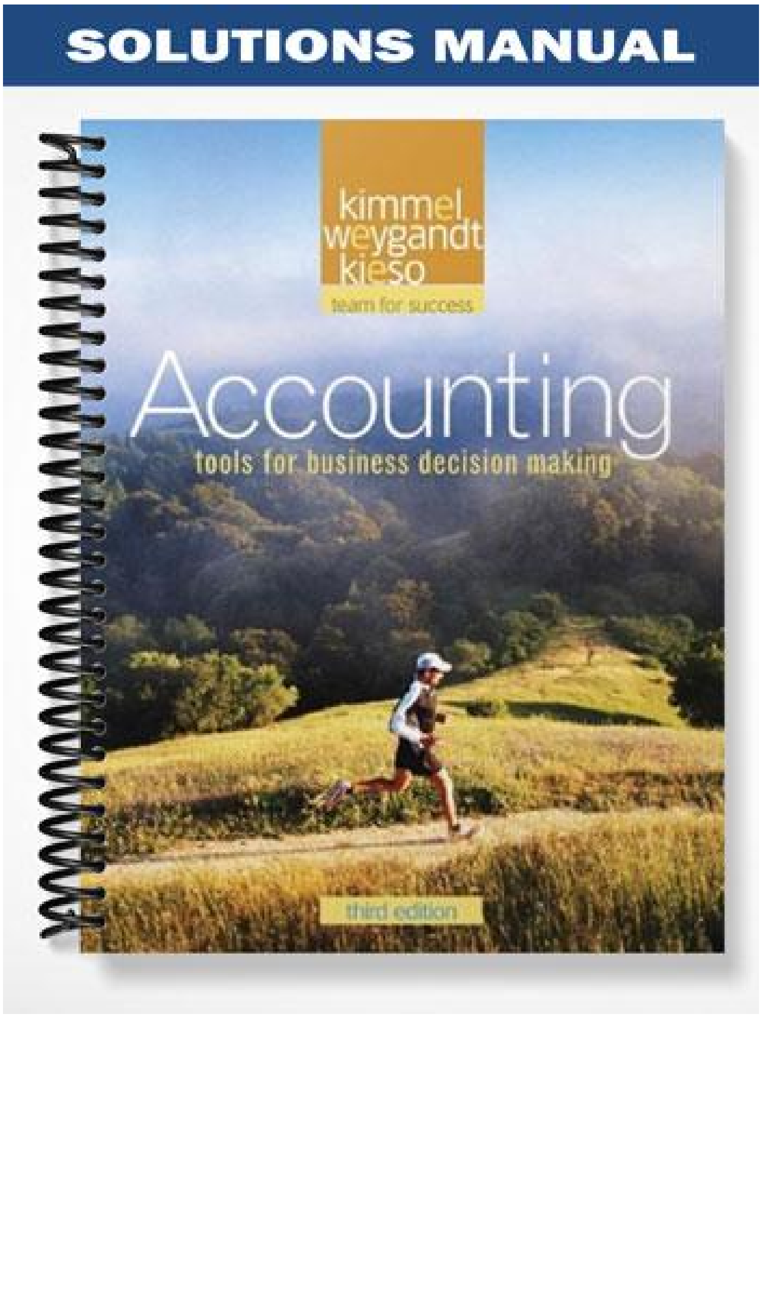
SOLUTIONS MANUAL




SOLUTIONS MANUAL
kimmel
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team for success
Accounting
tools for business decision making
third edition

CHAPTER 2

A Further Look at Financial Statements

ASSIGNMENT CLASSIFICATION TABLE

Study Objectives	Questions	Brief Exercises	Do It!	Exercises	A Problems	B Problems
1. Identify sections of a classified balance sheet.	1, 2, 3, 4, 5, 21	1, 2	1, 2	1, 2, 3, 4, 5, 6, 8	1, 2, 3	1, 2, 3
2. Identify and compute ratios for analyzing a company's profitability.	6, 7, 11,	3		7	4, 5, 6, 7	4, 5, 6, 7
3. Explain the relationship between a retained earnings statement and a statement of stockholders' equity.		4		8	2, 3	2, 3
4. Identify and compute ratios for analyzing a company's liquidity and solvency using a balance sheet.	6, 7, 8, 9, 10, 11	5, 6	3	8, 9, 10, 11	4, 5, 6, 7	4, 5, 6, 7
5. Use the statement of cash flows to evaluate solvency.	6, 7, 9, 10, 11	6	3	11	4, 5, 6, 7	4, 5, 6, 7
6. Explain the meaning of generally accepted accounting principles.	12, 13, 17	7			8	8
7. Discuss financial reporting concepts.	13, 14, 15, 16, 18, 19, 20	8, 9, 10, 11, 12	4	12, 13	8	8

ASSIGNMENT CHARACTERISTICS TABLE

Problem Number	Description	Difficulty Level	Time Allotted (min.)
1A	Prepare a classified balance sheet.	Simple	10–20
2A	Prepare financial statements.	Moderate	20–30
3A	Prepare financial statements.	Moderate	20–30
4A	Compute ratios; comment on relative profitability, liquidity, and solvency.	Moderate	20–30
5A	Compute and interpret liquidity, solvency, and profitability ratios.	Simple	10–20
6A	Compute and interpret liquidity, solvency, and profitability ratios.	Moderate	15–25
7A	Compute ratios and compare liquidity, solvency, and profitability for two companies.	Moderate	15–25
8A	Comment on the objectives and qualitative characteristics of Financial reporting.	Simple	10–20
1B	Prepare a classified balance sheet.	Simple	10–20
2B	Prepare financial statements.	Moderate	20–30
3B	Prepare financial statements.	Moderate	20–30
4B	Compute ratios; comment on relative profitability, liquidity, and solvency.	Moderate	20–30
5B	Compute and interpret liquidity, solvency, and profitability ratios.	Simple	10–20
6B	Compute and interpret liquidity, solvency, and profitability ratios.	Moderate	15–25
7B	Compute ratios and compare liquidity, solvency, and profitability for two companies.	Moderate	15–25
8B	Comment on the objectives and qualitative characteristics of accounting information.	Simple	10–20

ANSWERS TO QUESTIONS

1. A company's operating cycle is the average time that is required to go from cash to cash in producing revenues.

2. Current assets are cash and other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year of the balance sheet date or the company's operating cycle, whichever is longer. Current assets are listed in the order in which they are expected to be converted into cash.

3. Long-term investments are investments in stocks and bonds of other companies where the conversion into cash is not expected within one year or the operating cycle, whichever is longer. Property, plant, and equipment are tangible resources of a relatively permanent nature that are being used in the business and not intended for sale.

4. The major differences between current liabilities and long-term liabilities are:

Difference	Current Liabilities	Long-term Liabilities
Source of payment.	Existing current assets or other current liabilities.	Other than existing current assets or creating current liabilities.
Time of expected payment.	Within one year or the operating cycle, whichever is longer.	Beyond one year or the operating cycle.
Nature of items.	Debts pertaining to the operating cycle and other short-term debts.	Mortgages, bonds, and other long-term liabilities.

5. The two parts of stockholders' equity and the purpose of each are: (1) **Common stock** is used to record investments of assets in the business by the owners (stockholders). (2) **Retained earnings** is used to record net income retained in the business.

6. (a) Glenda is not correct. There are three characteristics: liquidity, profitability, and solvency.

(b) The three parties are not primarily interested in the same characteristics of a company. Short-term creditors are primarily interested in the liquidity of the enterprise. In contrast, long-term creditors and stockholders are primarily interested in the profitability and solvency of the company.

7. (a) Liquidity ratios: Working capital and current ratio.

(b) Solvency ratios: Debt to total assets and free cash flow.

(c) Profitability ratio: Earnings per share.

8. Debt financing is riskier than equity financing because debt must be repaid at specific points in time, whether the company is performing well or not. Thus, the higher the percentage of assets financed by debt, the riskier the company.

Questions Chapter 2 (Continued)

9. (a) Liquidity ratios measure the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.

(b) Profitability ratios measure the income or operating success of a company for a given period of time.

(c) Solvency ratios measure the company's ability to survive over a long period of time.

10. (a) The increase in earnings per share is good news because it means that profitability has improved.

(b) An increase in the current ratio signals good news because the company improved its ability to meet maturing short-term obligations.

(c) The increase in the debt to total assets ratio is bad news because it means that the company has increased its obligations to creditors and has lowered its equity "buffer."

(d) A decrease in free cash flow is bad news because it means that the company has become less solvent. The higher the free cash flow, the more solvent the company.

11. (a) The debt to total assets ratio and free cash flow which indicate the company's ability to repay the face value of the debt at maturity and make periodic interest payments.

(b) The current ratio and working capital, which indicate a company's liquidity and short-term debt-paying ability.

(c) Earnings per share indicates the earning power (profitability) of an investment.

12. (a) Generally accepted accounting principles (GAAP) are a set of rules and practices, having substantial support, that are recognized as a general guide for financial reporting purposes.

(b) The body that provides authoritative support for GAAP is the Financial Accounting Standards Board (FASB).

13. (a) The basic objective of financial reporting is to provide information useful for decision making.

(b) The qualitative characteristics are (1) relevance, (2) reliability, (3) comparability, and (4) consistency.

14. Morton is correct. Consistency means using the same accounting principles and accounting methods from period to period within a company. Without consistency in the application of accounting principles, it is difficult to determine whether a company is better off, worse off, or the same from period to period.

15. Comparability results when different companies use the same accounting principles. Consistency means using the same accounting principles and methods from year to year within the same company.

Questions Chapter 2 (Continued)

16. The two constraints are materiality and conservatism. The materiality constraint means that an item may be so small that failure to follow generally accepted accounting principles will not influence the decision of a reasonably prudent investor or creditor. The conservatism constraint means that when in doubt, the accountant chooses the accounting method that is least likely to overstate assets and net income.

17. There is little uniformity in accounting standards from country to country, although some efforts have been made in this area by the International Accounting Standards Board.

18. The going concern assumption lends credibility to the cost principle because it is assumed that the assets will be used in the business and what you gave up to acquire these assets is more relevant than what the assets could be sold for. If the company was not a going concern, items would be reported at liquidation value.

19. Cost is used as a basis for accounting treatment and reporting because it is both relevant and reliable. Cost is relevant because it represents the price paid, the assets sacrificed, or the commitment made at the date of acquisition. It is the amount for which someone or some entity should be accountable. Cost is reliable because it is objectively measurable, factual, and verifiable. It is the result of an arm's-length exchange transaction. As a result, cost is the basis used in preparing financial statements.

20. The economic entity assumption states that every economic entity can be separately identified and accounted for. This assumption requires that the activities of the entity be kept separate and distinct from (1) the activities of its owners (the shareholders) and (2) all other economic entities. A shareholder of a company charging personal living costs as expenses of the company is an example of a violation of the economic entity assumption.

21. At December 31, 2007 Tootsie Roll's largest current asset was Cash and Cash Equivalents of $57,606,000, its largest current liability is accrued liabilities of $42,056,000 and its largest item under other assets was trademarks of $189,024,000.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

CL	Accounts payable	CL	Income tax payable
CA	Accounts receivable	LTI	Investment in long-term bonds
PPE	Accumulated depreciation	PPE	Land
PPE	Building	CA	Merchandise inventory
CA	Cash	IA	Patent
IA	Goodwill	CA	Supplies

BRIEF EXERCISE 2-2

RONDELLI COMPANY
Partial Balance Sheet

Current assets	
Cash	$10,400
Short-term investments	8,200
Accounts receivable	14,000
Supplies	3,800
Prepaid insurance	3,300
Total current assets	$39,700

BRIEF EXERCISE 2-3

$$\text{Earnings per share} = \frac{\text{Net income} - \text{Preferred stock dividends}}{\text{Average common shares outstanding}}$$

$$= \frac{\$676 \text{ million}}{402 \text{ million shares}} = \$1.68 \text{ per share}$$

BRIEF EXERCISE 2-4

ICS	Issued new shares of common stock
DRE	Paid a cash dividend
IRE	Reported net income of $75,000
DRE	Reported net loss of $20,000

BRIEF EXERCISE 2-5

Working capital = Current assets – Current liabilities

Current assets	**$102,500,000**
Current liabilities	**201,200,000**
Working capital	**($ 98,700,000)**

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$102,500,000}{\$201,200,000}$$

$$= .51{:}1$$

BRIEF EXERCISE 2-6

(a) Current ratio $\dfrac{\$262,787}{\$293,625} = 0.89{:}1$

(b) Debt to total assets $\dfrac{\$376,002}{\$439,832} = 85.5\%$

(c) Free cash flow **$55,472 – $24,787 – $15,000 = $15,685**

BRIEF EXERCISE 2-7

(a) True.
(b) False.

BRIEF EXERCISE 2-8

(a) Forecasts/predicts.
(b) Confirms or corrects/provides feedback.
(c) Verifiable.
(d) Faithful representation.
(e) Comparability.

BRIEF EXERCISE 2-9

(a) Relevant.
(b) Reliability.
(c) Consistency.

BRIEF EXERCISE 2-10

(a) 1. Predictive value.
(b) 2. Neutral.
(c) 3. Verifiable.
(d) 4. Timely.

BRIEF EXERCISE 2-11

(c)

BRIEF EXERCISE 2-12

(a) Conservatism.
(b) Materiality.
(c) Materiality.

SOLUTIONS TO DO IT! REVIEW EXERCISES

DO IT! 2-1

THEREMIN CORPORATION
Balance Sheet (partial)
December 31, 2010

Assets		
Current assets		
Cash	$ 13,000	
Accounts receivable	22,000	
Inventory	58,000	
Supplies	9,000	
Total current assets		$102,000
Property, plant, and equipment		
Equipment	$180,000	
Less: Accumulated depreciation	45,000	135,000
Total assets		$237,000

DO IT! 2-2

IA	Trademarks	CA	Inventories
CL	Current maturities of long-term debt	PPE	Accumulated depreciation
NA	Interest revenue	PPE	Land improvements
CL	Taxes payable	SE	Common stock
LTI	Long-term marketable debt securities	NA	Advertising expense
CL	Unearned consulting fees	LTL	Mortgage note payable due in 3 years

DO IT! 2-3

(a)

2010

$$\frac{(\$80{,}000 - \$6{,}000)}{(40{,}000 + 75{,}000)/2} = \$1.29$$

2009

$$\frac{(\$40{,}000 - \$6{,}000)}{(30{,}000 + 40{,}000)/2} = \$0.97$$

Allotrope's profitability, as measured by the amount of income available for each share of common stock, increased by 33 percent (($1.29 – $0.97)/$0.97) during 2010. Earnings per share should not be compared across companies because the number of shares issued by companies varies widely. Thus, we cannot conclude that Allotrope Corporation is more profitable based on its higher EPS in 2010.

(b)

	2010	2009
Current ratio	$\frac{\$54{,}000}{\$24{,}000} = 2.25:1$	$\frac{\$36{,}000}{\$33{,}000} = 1.09:1$
Debt to total assets ratio	$\frac{\$72{,}000}{\$240{,}000} = 30\%$	$\frac{\$100{,}000}{\$205{,}000} = 49\%$

The company's liquidity, as measured by the current ratio improved from 1.09:1 to 2.25:1. Its solvency also improved, because the debt to total assets ratio declined from 49% to 30%.

(c)

Free cash flow 2010: $90,000 – $6,000 – $3,000 – $27,000 = $54,000
2009: $56,000 – $6,000 – $1,500 – $12,000 = $36,500

The amount of cash generated by the company above its needs for dividends and capital expenditures increased from $36,500 to $54,000.

DO IT! 2-4

1. **Monetary unit assumption**
2. **Reliability**
3. **Economic entity assumption**
4. **Conservatism**
5. **Consistency**
6. **Cost principle**
7. **Relevance**
8. **Time period assumption**
9. **Full disclosure principle**
10. **Materiality**
11. **Going concern assumption**
12. **Comparability**

SOLUTIONS TO EXERCISES

EXERCISE 2-1

CL	Accounts payable and accrued liabilities	CL	Income taxes payable
CA	Accounts receivable	CA	Inventories
PPE	Accumulated depreciation	LTI	Investments
PPE	Buildings	PPE	Land
CA	Cash and short-term investments	LTL	Long-term debt
CL	Dividends payable	CA	Materials and supplies
IA	Goodwill	PPE	Office equipment and furniture
		CA	Prepaid expenses

EXERCISE 2-2

CA	Prepaid expenses	LTI	Land held for future use
PPE	Machinery and equipment	IA	Patents
IA	Trademarks	LTL	Bonds payable
CL	Dividends payable	SE	Common stock
CL	Taxes payable	PPE	Accumulated depreciation
SE	Retained earnings	CL	Unearned revenue
CA	Accounts receivable	CA	Inventory

EXERCISE 2-3

BOEING COMPANY
Partial Balance Sheet
December 31, 2006
(in millions)

Assets		
Current assets		
Cash and cash equivalents	$ 6,118	
Short-term investments	268	
Accounts receivable	5,285	
Notes receivable—due before December 31, 2007	370	
Inventories	8,105	
Other current assets	2,837	
Total current assets		$22,983
Notes receivable—due after December 31, 2007		12,605
Property, plant, and equipment	19,310	
Less: Accumulated depreciation	11,635	7,675
Intangible assets		4,745
Other noncurrent assets		3,786
Total assets		$51,794

EXERCISE 2-4

H. J. HEINZ COMPANY
Partial Balance Sheet
May 2, 2007
(in thousands)

Assets

Current assets			
Cash and cash equivalents		$ 652,896	
Accounts receivable		996,852	
Inventories		1,197,957	
Prepaid expenses		132,561	
Other current assets		38,736	
Total current assets			$ 3,019,002
Property, plant, and equipment			
Land		51,950	
Buildings and equipment	$4,002,913		
Less: Accumulated depreciation	2,056,710	1,946,203	1,998,153
Intangible assets			4,139,872
Other noncurrent assets			875,999
Total assets			$10,033,026

EXERCISE 2-5

CLELAND COMPANY
Balance Sheet
December 31, 2010

Assets			
Current assets			
Cash		$11,840	
Accounts receivable		12,600	
Prepaid insurance		4,680	
Total current assets			$ 29,120
Property, plant, and equipment			
Land		61,200	
Building	$105,800		
Less: Accumulated depreciation—building	45,600	60,200	
Equipment	82,400		
Less: Accumulated depreciation—equipment	18,720	63,680	185,080
Total assets			$214,200
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable		$ 9,500	
Current portion of note payable		13,600	
Interest payable		3,600	
Total current liabilities			$ 26,700
Long-term liabilities			
Note payable ($93,600 – $13,600)			80,000
Total liabilities			106,700
Stockholders' equity			
Common stock		62,000	
Retained earnings ($40,000 + $5,500*)		45,500	
Total stockholders' equity			107,500
Total liabilities and stockholders' equity			$214,200

*Net income = $14,180 – $780 – $5,300 – $2,600 = $5,500

EXERCISE 2-6

TEXAS INSTRUMENTS, INC.
Balance Sheet
December 31, 2006
(in millions)

Assets		
Current assets		
Cash and cash equivalents	$ 1,183	
Short-term investments	2,534	
Accounts receivable	1,774	
Inventories	1,437	
Prepaid expenses	181	
Other current assets	745	
Total current assets		$ 7,854
Long-term investments		287
Property, plant, and equipment		
Property, plant, and equipment	7,751	
Less: Accumulated depreciation	(3,801)	3,950
Other noncurrent assets		1,839
Total assets		$13,930
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 560	
Note payable in 2007	43	
Other current liabilities	1,475	
Total current liabilities		$ 2,078
Noncurrent liabilities		
Noncurrent liabilities		492
Total liabilities		2,570
Stockholders' equity		
Common stock	2,624	
Retained earnings	8,736	
Total stockholders' equity		11,360
Total liabilities and stockholders' equity		$13,930

EXERCISE 2-7

(a) Earnings per share $= \dfrac{\text{Net income} - \text{Preferred stock dividends}}{\text{Average common shares outstanding}}$

2006 : $\dfrac{\$23,290,000 - 0}{(67,954,213 + 70,495,136) / 2} = \$.34$

2005 : $\dfrac{\$13,284,000 - 0}{(70,495,136 + 69,111,349) / 2} = \$.19$

(b) Using net income (loss) as a basis to evaluate profitability, Callaway Golf's income improved by 75% between 2005 and 2006. Its earnings per share increased by 79%.

(c) To determine earnings per share, dividends on preferred stock are subtracted from net income, but dividends on common stock are not subtracted.

EXERCISE 2-8

(a)

BARONE CORPORATION
Income Statement
For the Year Ended July 31, 2010

Revenues		
Commission revenue	$66,100	
Rent revenue	8,500	
Total revenues		$74,600
Expenses		
Salaries expense	51,700	
Utilities expense	22,600	
Depreciation expense	4,000	
Total expenses		78,300
Net loss		$(3,700)

BARONE CORPORATION
Retained Earnings Statement
For the Year Ended July 31, 2010

Retained earnings, August 1, 2009		$35,200
Less: Net loss	$3,700	
Dividends	4,000	7,700
Retained earnings, July 31, 2010		$27,500

(b)

BARONE CORPORATION
Balance Sheet
July 31, 2010

Assets

Current assets		
Cash	$29,200	
Accounts receivable	9,780	
Total current assets		$38,980
Property, plant, and equipment		
Equipment	$18,500	
Less: Accumulated depreciation	6,000	12,500
Total assets		$51,480

EXERCISE 2-8 (Continued)

(b)

BARONE CORPORATION
Balance Sheet (Continued)
July 31, 2010

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$ 4,100	
Salaries payable	2,080	
Total current liabilities		$ 6,180
Long-term note payable		1,800
Total liabilities		7,980
Stockholders' equity		
Common stock	16,000	
Retained earnings	27,500	
Total stockholders' equity		43,500
Total liabilities and stockholders' equity		$51,480

(c) $$\text{Current ratio} = \frac{\$38,980}{\$6,180} = 6.3:1$$

$$\text{Debt to total assets ratio} = \frac{\$7,980}{\$51,480} = 15.5\%$$

(d) The current ratio would not change because equipment is not a current asset and a 5-year note payable is a long-term liability rather than a current liability.

The debt to total assets ratio would increase from 15.5% to 39.1%*.

Looking solely at the debt to total assets ratio, I would favor making the sale because Barone's debt to total assets ratio of 15.5% is very low. Looking at additional financial data, I would note that Barone reported a significant loss for the current year which would lead me to question its ability to make interest and loan payments (and even remain in business) in the future. I would not make the proposed sale unless Barone convinced me that it would be capable of earnings in the future rather than losses.

I would also consider making the sale but requiring a substantial down-payment and smaller note.

*($7,980 + $20,000) ÷ ($51,480 + $20,000)

EXERCISE 2-9

(a)

	Beginning of Year	End of Year
Working capital	\$2,874 – \$1,623 = \$1,251	\$2,742 – \$1,433 = \$1,309
Current ratio	$\frac{\$2,874}{\$1,623}$ = 1.77:1	$\frac{\$2,742}{\$1,433}$ = 1.91:1

(b) Nordstrom's liquidity increased during the year. Its current ratio increased from 1.77:1 to 1.91:1. Also, Nordstrom's working capital increased by \$58 million.

(c) Nordstrom's current ratio at both the beginning and the end of the recent year exceeds Best Buy's current ratio for 2007 (and 2006). Nordstrom's end-of-year current ratio (1.91) exceeds Best Buy's 2007 current ratio (1.44). Nordstrom would be considered more liquid than Best Buy for the recent year.

EXERCISE 2-10

(a) Current ratio = $\frac{\$70,000}{\$40,000} = 1.8:1$

Working capital = \$70,000 – \$40,000 = \$30,000

(b) Current ratio = $\frac{\$45,000^{*}}{\$15,000^{**}} = 3.0:1$

Working capital = \$45,000 – \$15,000 = \$30,000

*\$70,000 – \$25,000 **\$40,000 – \$25,000

(c) Liquidity measures indicate a company's ability to pay current obligations as they become due. Satisfaction of current obligations usually requires the use of current assets.

If a company has more current assets than current liabilities it is more likely that it will meet obligations as they become due. Since working capital and the current ratio compare current assets to current liabilities, both are measures of liquidity.

EXERCISE 2-10 (Continued)

Payment of current obligations frequently requires cash. Neither work-ing capital nor the current ratio indicate the composition of current assets. If a company's current assets are largely comprised of items such as inventory and prepaid expenses it may have difficulty paying current obligations even though its working capital and current ratio are large enough to indicate favorable liquidity. In Greenstem's case, payment of $25,000 of accounts payable will leave only $5,000 cash. Since salaries payable will require $15,000, the company may need to borrow in order to make the required payment for salaries.

(d) The CFO's decision to use $25,000 of cash to pay off accounts payable is not in itself unethical. However doing so just to improve the year-end current ratio could be considered unethical if this action misled creditors. Since the CFO requested preparation of a "preliminary" balance sheet before deciding to pay off the liabilities he seems to be "managing" the company's financial position which is usually considered unethical.

EXERCISE 2-11

		2007	2006
(a)	Debt to total assets ratio	$\frac{\$570,172}{\$1,987,484} = 28.7\%$	$\frac{\$450,097}{\$1,605,649} = 28.0\%$
(b)	Free cash flow	$749,268 – $225,939 – $61,521 = $461,808	$480,419 – $81,545 – $42,058 = $356,816

(c) Using the debt to total assets ratio and free cash flow as measures of solvency produces mixed results for American Eagle Outfitters. Its debt to total assets ratio increased slightly from 28.0% for 2006 to 28.7% for 2007 indicating a decline in solvency for 2007. In contrast, its free cash flow increased by 29% indicating a good improvement in solvency.

(d) In both 2007 and 2006 American Eagle Outfitters's cash provided by operating activities was greater than the cash used for capital expenditures. It is generating plenty of cash from operations to cover its investing needs. This is not unusual for a company that has been operating successfully for more than ten years, as has been the case with American Eagle Outfitters. If it faced a deficiency, it could meet it by issuing stock or debt.

EXERCISE 2-12

(a) __2__ Going concern assumption
(b) __6__ Economic entity assumption
(c) __3__ Monetary unit assumption
(d) __4__ Time period assumption
(e) __5__ Cost principle
(f) __1__ Full disclosure principle

EXERCISE 2-13

(a) This is a violation of the cost principle. The inventory was written up to its market value when it should have remained at cost.

(b) This is a violation of the economic entity assumption. The treatment of the transaction treats Dipak Ghosh and Ghosh Co. as one entity when they are two separate entities. The cash used to purchase the truck should have been treated as part of salaries expense.

(c) This is a violation of the time period assumption. This assumption states that the economic life of a business can be divided into artificial time periods (months, quarters, or a year). By adding two more weeks to the year, Ghosh Co. would be misleading financial statement readers. In addition, 2010 results would not be comparable to previous years' results. The company should use a 52 week year.

SOLUTIONS TO PROBLEMS

PROBLEM 2-1A

YAHOO! INC.
Balance Sheet
December 31, 2006

Assets		
Current assets		
Cash and cash equivalents	$ 1,569,871	
Short-term investments	1,031,528	
Accounts receivable	930,964	
Prepaid expenses and other current assets	217,779	
Total current assets		$ 3,750,142
Long-term investments		2,827,720
Property and equipment, net		1,101,379
Intangible assets		3,374,379
Other assets		459,988
Total assets		$11,513,608
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 109,130	
Accrued expenses and other current liabilities	1,046,882	
Unearned revenue-current	317,982	
Total current liabilities		$ 1,473,994
Long-term liabilities		
Long-term debt	749,915	
Other long-term liabilities	129,089	
Total long-term liabilities		879,004
Total liabilities		2,352,998
Stockholders' equity		
Common stock	5,292,545	
Retained earnings	3,868,065	
Total stockholders' equity		9,160,610
Total liabilities and stockholders' equity		$11,513,608

PROBLEM 2-2A

FINN CORPORATION
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		$72,000
Expenses		
Salaries expense	$37,000	
Depreciation expense	3,300	
Insurance expense	2,200	
Utilities expense	2,000	
Repair expense	1,800	
Total expenses		46,300
Net income		$25,700

FINN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1, 2010	$31,000
Add: Net income	25,700
	56,700
Less: Dividends	12,000
Retained earnings, December 31, 2010	$44,700

PROBLEM 2-2A (Continued)

FINN CORPORATION
Balance Sheet
December 31, 2010

Assets		
Current assets		
Cash	$12,900	
Accounts receivable	14,200	
Prepaid insurance	3,500	
Total current assets		$30,600
Property, plant, and equipment		
Equipment	66,000	
Less: Accumulated depreciation	17,600	48,400
Total assets		$79,000
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$18,300	
Salaries payable	3,000	
Total current liabilities		$21,300
Stockholders' equity		
Common stock	13,000	
Retained earnings	44,700	
Total stockholders' equity		57,700
Total liabilities and stockholders' equity		$79,000

PROBLEM 2-3A

(a)

KILEY ENTERPRISES
Income Statement
For the Year Ended April 30, 2010

Revenues		$4,600
Expenses		
Cost of good sold	$990	
Wages expense	700	
Interest expense	400	
Depreciation expense	335	
Selling expenses	210	
Income tax expense	165	
Total expenses		2,800
Net income		$1,800

KILEY ENTERPRISES
Retained Earnings Statement
For the Year Ended April 30, 2010

Retained earnings, May 1, 2009	$1,600
Add: Net income	1,800
	3,400
Less: Dividends	325
Retained earnings, April 30, 2010	$3,075

PROBLEM 2-3A (Continued)

(b)

KILEY ENTERPRISES
Balance Sheet
April 30, 2010

Assets

Current assets		
Cash	$1,270	
Short-term investments	1,200	
Accounts receivable	810	
Inventories	967	
Prepaid expenses	12	
Total current assets		$4,259
Property, plant, and equipment		
Land	2,100	
Building, net of accumulated depreciation	1,537	
Equipment, net of accumulated depreciation	1,220	
Total property, plant, and equipment		$4,857
Total assets		$9,116

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$ 834	
Current portion of long term debt	450	
Wages payable	222	
Income taxes payable	135	
Total current liabilities		$1,641
Long term debt		3,500
Total liabilities		5,141
Stockholders' equity		
Common stock	900	
Retained earnings	3,075	
Total stockholders' equity		3,975
Total liabilities and stockholders' equity		$9,116

PROBLEM 2-4A

(a) Bedene Company appears to be more profitable.

Its net income for 2010 is $328,000 ($1,900,000 – $1,175,000 – $303,000 – $9,000 – $85,000). Its earnings per share is $3.28 ($328,000 ÷ 100,000 shares outstanding). Groneman's net income for 2010 is $142,200 ($620,000 – $340,000 – $98,000 – $3,800 – $36,000). Its earnings per share is $2.84 ($142,200 ÷ 50,000 shares outstanding).

(b) Bedene appears to be more liquid. Bedene's 2010 working capital of $340,875 ($407,200 – $66,325) is more than twice as high as Groneman's working capital of $149,988 ($190,336 – $40,348). In addition, Bedene's 2010 current ratio of 6.1:1 ($407,200 ÷ $66,325) is higher than Groneman's current ratio of 4.7:1 ($190,336 ÷ $40,348).

(c) Bedene appears to be slightly more solvent. Bedene's 2010 debt to total assets ratio of 18.6% ($174,825 ÷ $939,200)[a] is lower than Groneman's ratio of 21.2% ($69,968 ÷ $330,064)[b]. The lower the percentage of debt to total assets, the lower the risk that a company may be unable to pay its debts as they come due.

Another measure of solvency, free cash flow, also indicates that Bedene is more solvent. Bedene had $12,000 ($138,000 – $90,000 – $36,000) of free cash flow while Groneman had only $1,000 ($36,000 – $20,000 – $15,000).

[a]$174,825 ($66,325 + $108,500) is Bedene's 2010 total liabilities.
$939,200 ($407,200 + $532,000) is Bedene's 2010 total assets.

[b]$69,968 ($40,348 + $29,620) is Groneman's 2010 total liabilities.
$330,064 ($190,336 + $139,728) is Groneman's 2010 total assets.

PROBLEM 2-5A

(a) (i) Working capital = $428,900 – $215,500 = $213,400.

(ii) Current ratio = $\dfrac{\$428,900}{\$215,500}$ = 2.0:1.

(iii) Free cash flow = $190,800 – $92,000 – $31,000 = $67,800

(iv) Debt to total assets ratio = $\dfrac{\$415,500}{\$1,054,200}$ = 39.4%.

(v) Earnings per share = $\dfrac{\$133,100}{50,000 \text{ shares}}$ = $2.66.

(b) During 2010, the company's current ratio increased from 1.65:1 to 2.0:1 and its working capital increased from $160,500 to $213,400. Both measures indicate an improvement in liquidity during 2010.

The company's debt to total assets ratio increased from 31.0% in 2009 to 39.4% in 2010 indicating that the company is less solvent in 2010. Another measure of solvency, free cash flow, increased from $48,700 to $67,800. This suggests an improvement in solvency, thus we have conflicting measures of solvency.

Earnings per share decreased from $3.15 in 2009 to $2.66 in 2010. This indicates a decline in profitability during 2010.

PROBLEM 2-6A

	2009	2010
(a)	**Earnings per share.**	
	$\frac{\$50,000}{30,000 \text{ shares}} = \$1.67$	$\frac{\$70,000}{33,000 \text{ shares}} = \$2.12$
(b)	**Working capital.**	
	($20,000 + $62,000 + $73,000) – $70,000 = $85,000	($25,000 + $70,000 + $80,000) – $75,000 = $100,000
(c)	**Current ratio.**	
	$\frac{\$155,000}{\$70,000} = 2.2:1$	$\frac{\$175,000}{\$75,000} = 2.3:1$
(d)	**Debt to total assets ratio.**	
	$\frac{\$160,000}{\$685,000} = 23.4\%$	$\frac{\$155,000}{\$760,000} = 20.4\%$
(e)	**Free cash flow.**	
	$60,000 – $38,000 – $15,000 = $7,000	$87,000 – $45,000 – $20,000 = $22,000

(f) Net income and earnings per share have increased indicating that the underlying profitability of the corporation has improved. The liquidity of the corporation as shown by the working capital and the current ratio has improved slightly. Also, the corporation improved its solvency by improving its debt to total assets ratio as well as free cash flow.

PROBLEM 2-7A

	Ratio	Target	Wal-Mart
		(All Dollars Are in Millions)	
(a)	Working capital	\$14,706 – \$11,117 = \$3,589	\$46,588 – \$51,754 = (\$5,166)
(b)	Current ratio	1.3:1 (\$14,706 ÷ \$11,117)	.90:1 (\$46,588 ÷ \$51,754)
(c)	Debt to total assets ratio	58.1% (\$21,716 ÷ \$37,349)	59.3% (\$89,620 ÷ \$151,193)
(d)	Free cash flow	\$4,862 – \$3,928 – \$380 = \$554	\$20,209 – \$15,666 – \$2,802 = \$1,741
(e)	Earnings per share	$\$3.21 = \frac{\$2,787}{869}$	$\$3.02 = \frac{\$12,603}{4,168}$

(f) The comparison of the two companies shows the following:

Liquidity—Target's current ratio of 1.3:1 is much better than Wal-Mart's .90:1 and Target has significantly higher working capital than Wal-Mart.

Solvency—Wal-Mart's debt to total assets ratio is about 2% more than Target's but its free cash flow is much larger.

Profitability—Target's earnings per share is about 6% higher than Wal-Mart's.

PROBLEM 2-8A

(a) Financial reporting is the compilation and presentation of financial information for a company. It provides information in the form of financial statements and additional disclosures that is useful for decision making.

The accounting rules and practices that have substantial authoritative support and are recognized as a general guide for financial reporting purposes are referred to as generally accepted accounting principles (GAAP). The biotechnology company that employs Cindy will follow GAAP to report its assets, liabilities, stockholders' equity, revenues, and expenses as it prepares financial statements.

(b) Cindy is correct in her understanding that the low success rate for new biotech products will be a cause of concern for investors. Her suggestion that detailed scientific findings be reported to prospective investors might offset some of their concerns but it probably won't conform to the qualitative characteristics of accounting information.

These characteristics consist of relevance, reliability, comparability, and consistency. They apply to accounting information rather than the scientific findings that Cindy wants to include.

PROBLEM 2-1B

KELLOGG COMPANY
Balance Sheet
December 31, 2006
(in millions)

Assets		
Current assets		
Cash and cash equivalents	$ 410.6	
Accounts receivable, net	944.8	
Inventories	823.9	
Other current assets	247.7	
Total current assets		$ 2,427.0
Property, net		2,815.6
Other assets		5,471.4
Total assets		$10,714.0
Liabilities and Stockholders' Equity		
Current liabilities		
Notes payable	$ 1,268.0	
Accounts payable	910.4	
Current maturities of long-term debt	723.3	
Other current liabilities	1,118.5	
Total current liabilities		$ 4,020.2
Long-term liabilities		
Long-term debt	3,053.0	
Other long-term liabilities	1,571.8	
Total long-term liabilities		4,624.8
Total liabilities		8,645.0
Stockholders' equity		
Common stock	396.9	
Retained earnings	1,672.1	
Total stockholders' equity		2,069.0
Total liabilities and stockholders' equity		$10,714.0

PROBLEM 2-2B

PINSON, INC.
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		$53,000
Expenses		
Salaries expense	$36,000	
Depreciation expense	4,300	
Repair expense	2,900	
Utilities expense	2,100	
Insurance expense	1,200	
Total expenses		46,500
Net income		$ 6,500

PINSON, INC.
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1	$14,000
Plus: Net income	6,500
	20,500
Less: Dividends	3,600
Retained earnings, December 31	$16,900

PROBLEM 2-2B (Continued)

PINSON, INC.
Balance Sheet
December 31, 2010

Assets		
Current assets		
Cash	$ 5,300	
Accounts receivable	5,500	
Prepaid insurance	1,800	
Total current assets		$12,600
Property, plant, and equipment		
Equipment	31,000	
Less: Accumulated depreciation	(8,600)	22,400
Total assets		$35,000
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$10,200	
Salaries payable	2,000	
Total current liabilities		$12,200
Stockholders' equity		
Common stock	5,900	
Retained earnings	16,900	
Total stockholders' equity		22,800
Total liabilities and stockholders' equity		$35,000

PROBLEM 2-3B

(a)

MILNER CORPORATION
Income Statement
For the Year Ended April 30, 2010

Revenues		
Sales revenue		$21,450
Expenses		
Salaries expense	$6,840	
Depreciation expense	2,200	
Income tax expense	1,100	
Rent expense	760	
Interest expense	350	
Total expenses		11,250
Net income		$10,200

MILNER CORPORATION
Retained Earnings Statement
For the Year Ended April 30, 2010

Retained earnings, May 1, 2009	$13,960
Plus: Net income	10,200
	24,160
Less: Dividends	2,800
Retained earnings, April 30, 2010	$21,360

PROBLEM 2-3B (Continued)

(b)

MILNER CORPORATION
Balance Sheet
April 30, 2010

Assets

Current assets		
Cash	$21,955	
Accounts receivable	9,150	
Prepaid rent	380	
Total current assets		$31,485
Equipment	25,050	
Less: Accumulated depreciation	6,600	18,450
Total assets		$49,935

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$ 2,400	
Income taxes payable	300	
Interest payable	175	
Total current liabilities		$ 2,875
Long-term notes payable		5,700
Total liabilities		$ 8,575
Stockholders' equity		
Common stock	20,000	
Retained earnings	21,360	
Total stockholders' equity		41,360
Total liabilities and stockholders' equity		$49,935

(c) Milner Corporation reports its revenues and expenses on the income statement with net income being the result. Net income from the income statement is reported on the retained earnings statement as an item added to beginning retained earnings as part of the determination of retained earnings at year end. The year end retained earnings is then reported as part of stockholders' equity on the balance sheet.

PROBLEM 2-4B

(a) James appears to be more profitable. James's net income and earnings per share are higher than Smyth's.

James's net income is $148,000 ($898,000 – $620,000 – $55,000 – $10,000 – $65,000).

Its earnings per share is $.37 ($148,000 ÷ 400,000 shares).

Smyth's net income is $40,000 ($450,000 – $260,000 – $134,000 – $6,000 – $10,000).

Its earnings per share is $.20 ($40,000 ÷ 200,000 shares).

(b) James's 2010 working capital of $400,000 ($700,000 – $300,000) is over 3 times as high as Smyth's working capital of $105,000 ($180,000 – $75,000). However, James's 2010 current ratio of 2.3:1 ($700,000 ÷ $300,000) is slightly lower than Smyth's current ratio of 2.4:1 ($180,000 ÷ $75,000).

(c) Smyth appears to be less solvent. Smyth's 2010 debt to total assets ratio of 34% ($265,000 ÷ $780,000)[a] is slightly higher than James's ratio of 33% ($500,000 ÷ $1,500,000)[b]. The lower the percentage of debt to total assets, the lower the risk that a company may be unable to pay its debts as they come due.

Smyth's free cash flow is only $12,000 ($36,000 – $20,000 – $4,000) compared to $115,000 ($180,000 – $50,000 – $15,000) for James. More free cash flow indicates that James will be better able to finance more capital expenditures without taking on more debt.

[a]$265,000 ($75,000 + $190,000) is Smyth's 2010 total liabilities.
$780,000 ($180,000 + $600,000) is Smyth's 2010 total assets.

[b]$500,000 ($300,000 + $200,000) is James's 2010 total liabilities.
$1,500,000 ($700,000 + $800,000) is James's 2010 total assets.

PROBLEM 2-5B

(a) (i) Current ratio = $\frac{\$319{,}100}{\$149{,}200}$ = 2.1:1.

(ii) Working capital = $319,100 – $149,200 = $169,900.

(iii) Debt to total assets ratio = $\frac{\$279{,}200}{\$784{,}400}$ = 36%.

(iv) Free cash flow = $71,300 – $42,000 – $10,000 = $19,300.

(v) Earnings per share = $\frac{\$99{,}200}{65{,}000}$ = $1.53.

(b) During 2010, Windsor's current ratio decreased from 2.4:1 to 2.1:1 and its working capital dropped from $178,000 to $169,900. Both measures indicate a slight decline in liquidity during 2010.

Windsor's debt to total assets ratio increased from 31% in 2009 to 36% in 2010 indicating that the company is less solvent in 2010. Using another measure of solvency, free cash flow, we see that Windsor's solvency has improved during 2010. Earnings per share increased from $1.35 to $1.53 in 2010. This 13% increase indicates better profitability in 2010.

PROBLEM 2-6B

	2009	2010
(a)	**Earnings per share.**	
	$\frac{\$163,000}{320,000 \text{ shares}} = \$.51$	$\frac{\$140,000}{370,000 \text{ shares}} = \$.38$
(b)	**Working capital.**	
	($24,000 + $55,000 + $73,000) – $75,000 = $77,000	($40,000 + $90,000 + $74,000) – $93,000 = $111,000
(c)	**Current ratio.**	
	$\frac{\$152,000}{\$75,000} = 2.03:1$	$\frac{\$204,000}{\$93,000} = 2.19:1$
(d)	**Debt to total assets.**	
	$\frac{\$145,000}{\$649,000} = 22.3\%$	$\frac{\$183,000}{\$807,000} = 22.7\%$
(e)	**Free cash flow.** $178,000 – $45,000 – $43,000 = $90,000	**Free cash flow.** $165,000 – $85,000 – $50,000 = $30,000

(f) The underlying profitability of the corporation as measured by earnings per share has declined. The liquidity of the corporation improved as shown by the increase in working capital and the current ratio. Also, the corporation appears to be increasing its debt burden as its debt to total assets increased slightly indicating a decrease in solvency. Comparing free cash flow, we find a drop in this measure of solvency also.

PROBLEM 2-7B

	Ratio	Blockbuster Inc	Movie Gallery, Inc.
		(All Dollars Are in Millions)	
(a)	Working capital	\$171 (\$1,566 – \$1,395)	(\$29) (\$239 – \$268)
(b)	Current ratio	1.12:1 (\$1,566 ÷ \$1,395)	.89:1 (\$239 ÷ \$268)
(c)	Debt to total assets ratio	71.6% (\$2,246 ÷ \$3,137)	120.6% (\$1,390 ÷ \$1,153)
(d)	Free cash flow	\$329 – \$79 – \$11 = \$239	(\$10) – \$20 – \$0 = (\$30)
(e)	Earnings (Loss) per share	$\$0.29 = \dfrac{\$55 - 0}{189.0}$	$(\$0.82) = \dfrac{(\$26) - 0}{31.8}$

(f) **The comparison of the two companies shows the following:**

<u>Liquidity</u>—Blockbuster's current ratio is 1.12:1 compared to Movie Gallery's .89:1. Its working capital is \$171 compared to Movie Gallery's negative \$29. Blockbuster is much more liquid than Movie Gallery using either indicator.

<u>Solvency</u>—Blockbuster is more solvent than Movie Gallery because its ratio of debt to total assets is significantly lower and its free cash flow is much larger.

<u>Profitability</u>—The profit picture is bleak for Movie Gallery. It reported an \$0.82 loss per share compared to Blockbuster's \$0.29 *earnings* per share.

PROBLEM 2-8B

(a) The primary objective of financial reporting is to provide information useful for decision making. Since Net Nanny's shares appear to be actively traded, investors must be capable of using the information made available by Net Nanny to make decisions about the company.

(b) The investors must feel as if the company will show earnings in the future. They must recognize that information relevant to their investment choice is indicated by more than Net Nanny's net income.

(c) The change from Canadian dollars to U.S. dollars for reporting purposes should make Net Nanny more comparable with companies traded on U.S. stock exchanges.

BYP 2-1 FINANCIAL REPORTING PROBLEM

(a) **Total current assets were $199,726,000 at December 31, 2007, and $190,917,000 at December 31, 2006.**

(b) **Current assets are properly listed in the order of liquidity. As you will learn in a later chapter, inventories are considered to be less liquid than receivables. Thus, they are listed below receivables and before prepaid expenses.**

(c) **The asset classifications are similar to the text: (a) current assets, (b) property, plant, and equipment, and (c) other assets.**

(d) **Total current liabilities were $57,972,000 at December 31, 2007, and $62,211,000 at December 31, 2006.**

BYP 2-2 COMPARATIVE ANALYSIS PROBLEM

(a)

($ in thousands)	Hershey Foods	Tootsie Roll
1. Working capital	$1,426,574 – $1,618,770 = ($192,196)	$199,726 – $57,972 = $141,754
2. Current ratio	$1,426,574 ÷ $1,618,770 = .88:1	$199,726 ÷ $57,972 = 3.4:1
3. Debt to total assets ratio	$\frac{\$3,623,593}{\$4,247,113} = 85.3\%$	$\frac{\$174,495^*}{\$812,725} = 21.5\%$
4. Free cash flow	$778,836 – $189,698 – $252,263 = $336,875	$90,064 – $14,767 – $17,542 = $57,755
5. Earnings per share	$\frac{\$214,154 - 0}{\$228,652} = \$0.94$	$\frac{\$51,625 - 0}{54,980} = \$0.94$

*$57,972 + $116,523

(b) *Liquidity*

Tootsie Roll is much more liquid since it has over $330 million more working capital than Hershey. In addition, Tootsie Roll's current ratio is almost four times as large as Hershey's.

Solvency

Based on the debt to total assets ratio, Tootsie Roll is more solvent. Tootsie Roll's debt to total assets ratio is significantly lower than Hershey's and, therefore, Tootsie Roll would be considered better able to pay its debts as they come due.

Comparing free cash flow, Hershey generates much more excess cash, but both companies generate significant amounts of cash to pay debt, distribute dividends, or expand operations.

Profitability

Earnings per share of the two companies are the same. It should be noted that additional measures of profitability are needed to provide a better picture for comparison.

BYP 2-3 RESEARCH CASE

(a) In 2007, 56% of survey respondents said that they had observed violations of company ethics standards, policy, or the law. This compares with 52% in 2005 and only 46% in 2003.

(b) The three most frequent types of observed misconduct were conflicts of interest (23%), abusive or intimidating behavior (21%) and lying to employees (20%).

(c) More than 42% of employees who witnessed misconduct didn't report it through company channels. The two most common reasons given for not reporting were a belief that reporting wouldn't lead to corrective action (54%) and fear of retaliation (36%).

(d) The key elements of an effective ethics and compliance program are:

- Employees are willing to seek advice about ethics questions.
- Employees feel prepared to handle situations that could lead to misconduct.
- Employees are rewarded for ethical behavior.
- Employees do not believe their company rewards success obtained through questionable means.
- Employees feel positive about their company.

BYP 2-4 INTERPRETING FINANCIAL STATEMENTS

(a) The percentage decrease in Gap's total assets during this period is calculated as:

$$\frac{\$8,544 - \$10,283}{\$10,283} = 17\%$$

The average decrease per year can be approximated as:

$$\frac{17\%}{4 \text{ years}} = 4\% \text{ per year}$$

(b) Gap's working capital decreased during this period while its current ratio increased slightly, indicating a decline in liquidity. The current ratio is a better measure of liquidity because it provides a relative measure; that is, current assets compared to current liabilities. Working capital only tells us the net amount of current assets less current liabilities. It is hard to say whether a given amount of working capital is adequate or inadequate without knowing the size of the company.

(c) The decrease in the debt to total assets ratio suggests that Gap's solvency improved during the period, as the percentage of debt used to finance its assets decreased. Debt to total assets peaked at .66:1 in 2002 and then declined to .38:1 by 2005.

(d) The earnings per share suggests that Gap's profitability improved significantly from 2002 to 2004, increasing from $.55 to $1.29. However, based on the years shown, it appears that earnings varied a great deal during this period. An investor would want to evaluate the causes of the 25% decline in 2006 to predict the likelihood of future decreases in earnings.

FINANCIAL ANALYSIS ON THE WEB

BYP 2-5

Answers will vary depending on company chosen and date.

BYP 2-6

Answers will vary depending on company chosen and date.

BYP 2-7 DECISION MAKING ACROSS THE ORGANIZATION

The current ratio increase is a favorable indication as to liquidity, but alone tells little about the prospects of the client. From this ratio change alone, it is impossible to know the amount and direction of the changes in individual accounts, total current assets, and total current liabilities. Also unknown are the reasons for the changes.

The working capital increase is also a favorable indication as to liquidity, but again the amount and direction of the changes in individual current assets and current liabilities cannot be determined from this measure.

The increase in free cash flow is a favorable indicator for solvency. An increase in free cash flow means the company can replace assets, pay dividends, and have "free cash" available to pay down debt or expand operations.

The decrease in the debt to total assets ratio is a favorable indicator for solvency and going-concern prospects. The lower the percentage of debt to total assets, the lower the risk that a company may be unable to pay its debts as they come due. A decline in the debt to total assets ratio is also a positive sign regarding going-concern potential.

The increase in net income is a favorable indicator for both solvency and profitability prospects although much depends on the quality of receivables generated from sales and how quickly they can be converted into cash. A significant factor here may be that despite a decline in sales the client's management has been able to reduce costs to produce this increase. Indirectly, the improved income picture may have a favorable impact on solvency and going-concern potential by enabling the client to borrow currently to meet cash requirements.

The earnings per share increase is a favorable indicator for profitability. A 109% (from $1.15 to $2.40) increase indicates a significant increase in net income and provides a favorable sign regarding going-concern potential.

BYP 2-8 COMMUNICATION ACTIVITY

To: T. J. Rains

From: Accounting Major

Subject: Financial Statement Analysis

(a) Ratios can be classified into three types, which measure three different aspects of a company's financial health:

1. Liquidity ratios—These measure a company's ability to pay its current obligations.

2. Solvency ratios—These measure a company's ability to pay its long-term obligations and survive over the long-term.

3. Profitability ratios—These measure the ability of the company to generate a profit.

(b) 1. Examples of liquidity measures are:

Working capital = Current assets – Current liabilities

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

2. Examples of solvency measures are:

$$\text{Debt to total assets ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Free cash flow = Cash provided by operating activities – Capital expenditures – Cash dividends

BYP 2-8 (Continued)

3. **Example of profitability measure:**

$$\text{Earnings per share} = \frac{\text{Net income} - \text{Preferred stock dividends}}{\text{Average common shares outstanding}}$$

(c) There are three bases for comparing a company's results:

The bases of comparison are:

1. **Intracompany—This basis compares an item or financial relationship within a company in the current year with the same item or relationship in one or more prior years.**
2. **Industry averages—This basis compares an item or financial relationship of a company with industry averages (or norms).**
3. **Intercompany—This basis compares an item or financial relationship of one company with the same item or relationship in one or more competing companies.**

BYP 2-9 ETHICS CASE

(a) The stakeholders in this case are: Boeing's management; CEO, public relations manager, Boeing's stockholders, McDonnell Douglas stock-holders, other users of the financial statements; especially potential investors of the new combined company.

(b) The ethical issues center around full disclosure of financial information. Management attempted to "time" the release of bad news in order to complete a merger that would have been revoked if cost overruns had been disclosed as soon as management became aware of them.

(c) The time period assumption requires that financial results be reported on specific, pre-determined dates.

The full disclosure principle requires that all circumstances and events that make a difference to financial statement users must be disclosed.

(d) It is not ethical to "time" the release of bad news. GAAP requires that all significant financial information be released to allow users to make informed decisions.

(e) Answers will vary. One possibility: Release the information regarding cost overruns as it became available. Describe the causes of such overruns and explain how Boeing would address them (probably by improving production methods to eliminate the inefficiencies alluded to in the text).

(f) Investors and analysts should be aware that Boeing's management will probably "manage" information in the future in ways that will interfere with full disclosure.

BYP 2-10 ALL ABOUT YOU ACTIVITY

Answers will vary.